★ A NEW WORLD ★

ASIAN FAMILIES MAY WISH TO CONSIDER THE UNFAMILIAR CONCEPT OF THE TRUST IN THEIR PLANNING FOR US ASSETS, WRITES **LUCY S LEE**

'Globalisation has added fuel to the fire of complexity'

IN TODAY'S MULTIFACETED and instantaneous world, where traditional notions are struggling to adapt to the popular thinking du jour, it might seem nearly impossible to find common ground on any key issue. But, despite the differences in generations, cultures and ideology, there is one 'ugly truth' common across the world: each tax system is unique, yet impressively complex, and, despite its application to (almost) everyone living under that system, only a few truly understand it. Indeed, the US *Internal Revenue Code* and *Treasury Regulations* contain more than ten million words.

Globalisation has added fuel to the fire of complexity. In the current climate of global connectivity, it has become commonplace for individuals to engage in cross-border transactions, and the concept of global residence has become a trendy model of living. Thus, today, one must often grapple with the tax systems of multiple jurisdictions.

US ESTATE AND GIFT TAX

In the US, like many other countries, the estate and gift taxation of individuals is no less complex than income taxation. In fact, the US estate and gift taxation of individuals is highly fact-intensive and varies depending on the location of domicile, the location and category of assets involved, and the timing of the transfer. Generally, an individual who is not a US citizen and does not have US domicile (a non-resident alien, or NRA) is subject to US estate and gift tax only with respect to transfers of property considered to be located in the US (US *situs* assets).[1]

So why should an NRA without US nexus need to worry about US estate or gift tax? For starters, 'domicile' and 'US *situs*' are terms of art, with particular nuances in application that can serve as landmines for the unwary.[2]

Notwithstanding that the categorisation of assets as 'US *situs*' is generally aligned for purposes of US estate and gift taxation, there are several notable differences. Post-mortem bequests of interests in US companies and US marketable securities from an NRA are subject to the US estate tax,[3] but lifetime gifts of such assets are not subject to the US gift tax.[4] Similarly, an NRA's lifetime gifts of cash in a US bank account are subject to the US gift tax, even if sent by a wire transfer,[5] but post-mortem bequests of such assets are not subject to the US estate tax.

Moreover, many NRAs may have family members who are or may be US persons,[6] which can impact current planning, including existing trusts. Finally, it is possible for NRAs to acquire US *situs* assets (e.g. US real estate). As a non-domiciliary of the US, an NRA will be allowed an exemption of USD60,000, and the remainder of US *situs* assets will be subject to the US estate tax at 40 per cent (unless otherwise provided by an applicable treaty).

POPULAR PRACTICES IN ASIA

With the ageing of the baby boomer generation, it is expected that billions of dollars of assets will change hands in the foreseeable future. Many of the typical estate plans that have been put in place could be structured strictly from a 'one country' point of view, and may not accommodate changes in family members or assets, including if an NRA undertakes

KEY POINTS

WHAT IS THE ISSUE?
The effective use of a trust in estate planning for Asian families where the patriarch/matriarch is a non-US person but has US descendants.

WHAT DOES IT MEAN FOR ME?
There are opportunities to incorporate trusts in estate planning as an effective wealth management tool, providing asset protection and preventing tax issues.

WHAT CAN I TAKE AWAY?
Advisors should investigate all relevant facts and background, and consider creative structures and uses of a trust.

estate planning on their own, without considering the potential US tax impact to heirs.

One example of 'DIY' estate planning[7] involves creating a financial account for each child in the family and transferring assets, including shares of closely held companies. The idea is to make gradual transfers over an extended period of time, such as to avoid or minimise local-level gift taxation. Typically, an NRA will create the account in the child's name, but continue to manage it directly or through a delegate, and control absolutely any disbursements. The child will often be oblivious to the existence of the account, and if they do have some idea, it may be limited to simply knowing that the NRA has made some provision.

The problem with this DIY approach is the 'one country' focus. Unbeknown to the child, NRAs may file tax returns and pay taxes in the country in which the account is located and thus believe the account is fully tax compliant. What the NRA did not consider is the child's US tax obligations, including Foreign Bank Account Reports and other information returns (e.g. Form 8938, Form 5471 and Form 8621). In the post-Swiss bank era, when international tax enforcement of offshore accounts became a paramount goal of the US government, this DIY planning became an enormous (and costly) problem.

TRUST RECOGNITION IN THE LOCAL COUNTRY

So what could the NRA have done differently? One possible solution may have been to establish a trust for the benefit of the child.[8] Note that many families in certain Asian countries, including South Korea, are not very familiar with the concept of a trust in estate planning. Some countries do not recognise a trust as a legal arrangement and, in the case of South Korea, though the use of a trust in estate planning was legalised in 2012, there is not yet an established body of law governing the taxation of trusts and their related persons.

In our example, an NRA could have established a trust for the benefit of the child. Note that a trust established under US law can be structured as a foreign trust for the purpose of US taxes by having an NRA grantor or a non-US person with the ability to control the trust.

If an NRA can structure the trust as a grantor trust for US tax purposes, there can be significant tax advantages for the child. The advantage of establishing a grantor trust with a non-US grantor is that the trust is not distinguishable from the non-US grantor and, therefore, all income should be considered taxable to the grantor (whether or not it is actually taxed). As a non-resident, an NRA should be subject to US income tax only on items of income considered to be sourced from or connected to the US. Moreover, it should be possible to limit the NRA's exposure to US estate tax even on US *situs* assets.

Because NRAs should be indistinguishable from the trust for US tax purposes, other beneficiaries can receive tax-free distributions from the trust. Such distributions should be treated as 'gifts' from an NRA to the beneficiary, which are reportable but not taxable. Moreover, upon the death of an NRA, basis in the trust assets should be 'stepped up' to the fair market value.

If the trust is structured as a foreign non-grantor trust, the child will be subject to US tax on any distributions of income from the trust, and there must be careful consideration regarding distributions of accumulated income. However, the trust can be an effective US estate tax blocker for the family.

An effective estate plan should start with an effective wealth management plan that also manages the income tax impact. Although planning with a non-US grantor can be highly advantageous, such planning is highly complex and requires careful attention to myriad special rules and exceptions. But there can be significant advantages while being tax compliant globally. Finally, putting aside tax, depending on the location of an NRA's residence, there may be succession laws in place that can limit an NRA's freedom of allocating their assets among their heirs. In this regard, using a trust may provide a mechanism for restoring the power to an NRA's hands.

1 IRC §§ 2001(a) and 2501(a); Treas Reg § 20.0-1(b)(1). The estate and gift tax are imposed at 40 per cent on the gross value of the US *situs* assets, less exemptions **2** US *situs* assets generally include, among others, US real estate held directly or indirectly through a company, tangible personal property located in the US (e.g. artwork, jewellery and automobiles), and currency in a US safe deposit box **3** IRC § 2104(a); Treas Reg § 20.2104-1(a)(5) **4** Treas Reg § 25.2511-3(a)(1) **5** Treas Reg § 20.2104-1(a)(2); see also GCM 36860 (24 September 1976) **6** In this article, the term 'US persons' generally refers to individuals who are citizens or residents of the US because of their immigration status (i.e. green card) or based on a substantial number of days spent in the US under IRC § 7701(b)(3) **7** This type of DIY estate planning appears to be particularly common with Korean families, although we see it often with families throughout other parts of Asia and Europe **8** Indeed, in certain tax audits involving similar types of DIY estate planning, it was possible to convince the US government that the financial account was a de facto, i.e. constructive, trust

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